



March 12, 2004

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th and C Streets, N.W.
Washington, DC 20551

Re: Docket No. R-1176 - Comments to Proposed Amendments to Regulation CC

Dear Ms. Johnson:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the interests of our nation's federal credit unions, I am responding to the Federal Reserve Board's (Board) request for comment on the proposed amendments to Regulation CC and its commentary for the purpose of implementing the Check Clearing for the 21st Century Act (Check 21).

To promulgate regulations for Check 21, the Board proposes to modify Regulation CC, including adding a new subpart D with commentary. Furthermore, in response to inquiries received by the Board staff and changed circumstances affecting relevant provisions, the Board proposes amendments to clarify some of the existing provisions of the rule and commentary. Finally, in addition to the specific requests for comment on proposed changes to Regulation CC, the Board requests comments on the following three issues: (1) the treatment of generally applicable industry standards, (2) the relation of Check 21 to other law, and (3) remotely-created demand drafts. NAFCU commends the Board for its swift action in creating and proposing implementing regulations for Check 21, and NAFCU offers the following comments in response to the Board's request. In addition, NAFCU will submit comments as part of a separate industry group joint letter.

Proposed Changes to Regulation CC: Implementation of Check 21

The proposed amendments to Regulation CC would add a new subpart D, with commentary. Subpart D would contain provisions relating specifically to Check 21. NAFCU offers the following comments on the Board's proposal regarding the substitute check legal equivalence, warranties, expedited recredit provisions, and consumer awareness disclosures.

Substitute Checks: Legal Equivalence Issues

Legal Equivalence and MICR Repair

Section 229.51(a) of the proposed rule provides that a substitute check for which a financial institution has provided the substitute check warranties is the legal equivalent of the original check for all purposes and all persons if it meets the accuracy and legend requirements. The commentary also provides clarification about what information on the check must be accurately represented as a prerequisite for legal equivalence. The proposal provides that the failure to correct the amount on the MICR field of the substitute check does not affect the status of the substitute check as the legal equivalence of the original check. However, the proposal also states that a substitute check that does not have the correct routing and transit number would not be a legal equivalent of the original check but would carry the warranties, indemnity, and recredit rights under the Check 21 Act.

NAFCU believes that, while there should be no obligation under Check 21 for a collecting bank or paying bank to repair the MICR line on a substitute check, the final regulations should provide that a financial institution may, at its option, repair any portion of a MICR line on a substitute check that it receives in the check collection process. Furthermore, a substitute check that is repaired should not lose its "legal equivalent" status, regardless of the type or the accuracy of the repair. A financial institution that repairs a substitute check would not make a warranty under Check 21 that the MICR line accurately reflects the MICR line on the original check. Rather, if a financial institution failed to repair a substitute check MICR line accurately, it would constitute a breach of encoding warranties under U.C.C and Regulation CC rules. NAFCU requests the Board to provide additional clarification on the rights and duties concerning MICR repair following the creation of a substitute check (including the steps that a reconverting bank must follow when repairing a substitute check).

Legal Equivalence and Purported Substitute Checks

The Board requests comment on whether an item that purports to be, but is not, a substitute check should carry the warranty and indemnity rights and, where applicable, recredit and consumer awareness disclosure rights as though it were a substitute check. NAFCU agrees that an item which purports to be a substitute check should carry warranty, indemnity and recredit rights. If an item is presented as a substitute check, but does not in fact meet the requirements of such a document, the paying institution should consider this check for settlement of payment, including warranty and indemnity rights. The responsibility and the risks associated with substitute checks should be borne by the converting financial institution. Nonetheless, NAFCU has concerns about the Board's proposal that the purported check will not be the legal equivalent of the original check. If the substitute check is not the legal equivalent of the original check, a collecting financial institution would not have the legal authority to repair the substitute check or to present the check to the paying financial institution for payment. Similarly, a paying bank or credit union would not have the legal authority to charge its member's account, even if it could be determined that the substitute check was otherwise properly payable. NAFCU strongly

urges the Board to revise this section of the proposed regulation and provide further guidance on this important issue.

Check 21 Warranties: Applicability to ACH and Electronic Funds Transfers

The Board seeks comment on whether a duplicate debit resulting from an ACH debit that was created using information from an original check or substitute check should result in a violation of Check 21's duplicate payment warranty. NAFCU does not support application of the Check 21 warranties to a second debit that results from an ACH debit. An ACH transaction represents a new payment transaction and it not a continuation of a check transaction. ACH warranties already provide that the originating depository financial institution warrants that the ACH debit entry is authorized; therefore, it is unnecessary to subject an originator of an ACH debit entry to a second set of warranties under Check 21. NAFCU believes that both ACH and electronic funds transfer rules provide consumers with ample protection and apply appropriate liabilities for originators of ACH debits and, therefore, that Check 21 warranties should not apply.

Expedited Recredit

The procedures for expedited recredit for consumers are outlined in proposed § 229.54, which sets forth the circumstances giving rise to a consumer expedited recredit claim, the time period and procedures for making such a claim, the conditions for a recredit, the timing and availability of a recredit, the financial institution's ability to reverse a recredit on a later determination that the consumer's claim was not valid, and the notices a financial institution must provide in connection with recredit claims. NAFCU offers the following comments on the proposed time period calculations, financial institution required actions, reversal of interest, and the model disclosures for expedited recredit claims.

Time Period Calculations

Section 229.54(b) sets forth the time period and procedures for consumers who are making a recredit claim. The proposed rule clarifies that when a financial institution requires the consumer claim to be in writing, the financial institution must compute the time period for acting on the claim from the date the consumer submitted the written claim, even if the consumer previously provided some information relating to the claim in another form. Additionally, Check 21 measures time from the "business day" on which the claim was received. The Board, however, alternatively proposes to incorporate the term "banking day," as it has for other parts of Regulation CC.

NAFCU supports the Board's proposal to permit a financial institution to compute the time period for acting on a claim required to be in writing from the date the consumer submits the claim. Furthermore, NAFCU recommends the Board clarify that a claim is deemed submitted on the date it is *received* by the financial institution, rather than from the date the consumer *sends* the claim notice. NAFCU also supports the Board's proposal to incorporate the

term “banking day” rather than using “business day.” This proposal will maintain uniformity among terms throughout Regulation CC.

Action on Claims

Check 21 sets forth the requirements for financial institutions to follow when processing a consumer’s expedited recredit claim. The Board’s proposed rule incorporates each of Check 21’s substantive requirements but reorganizes those requirements in a way that the Board believes is more straightforward. NAFCU supports the Board’s proposed reorganization of the statutory provisions and believes that it will enable financial institutions to more readily understand their responsibilities with regard to recredit claims.

Reversal of Interest Recredit

Check 21 does not explicitly address the reversal of interest when reversing a recredit, and the Board specifically requests comment on whether the approach in the proposed rule is appropriate. NAFCU supports the Board’s proposed approach. In the event the financial institution determines that the consumer claim is not valid, the financial institution should be allowed to reverse the entire amount of the recredit, including any interest recredited to the consumer. The proposed rule will prevent any unjust enrichment that could occur to consumers, which, in turn, could lead to false claims causing an unnecessary burden to financial institutions.

Expedited Recredit Disclosures

Although not required to do so by Check 21, the Board’s proposal includes Appendix C models for the notices that a financial institution must provide in response to a consumer’s expedited recredit claim. While no statutory safe harbor applies to these proposed model notices, the Board believes that they may assist financial institutions with complying with the regulation. NAFCU supports the Board’s proposed model notices and believes that they are well written and concise.

Consumer Awareness Disclosure

Check 21 requires financial institutions to provide a consumer awareness disclosure regarding substitute checks and substitute check rights to each consumer who receives original checks or substitute checks. The disclosures are intended for either consumers who routinely receive paid checks with their account statements, or consumers who receive substitute checks only on a case-by-case basis. NAFCU offers the following comments on the content and delivery of the notice.

Content of Notice

Check 21 tasks the Board with publishing model forms that financial institutions can use to satisfy the content requirement of the consumer awareness disclosure. The Board proposes to include the required model disclosure as model C-5A in Appendix C. Financial institutions that

use this model are given a “safe harbor” if the form accurately describes the financial institution’s policies and practices. The Board requests comment on whether the proposed model disclosure is clear, accurate, and concise.

Check 21 requires financial institutions to provide a “brief notice” regarding the legal equivalency of the substitute check and the consumer recredit rights. NAFCU believes that the proposed notice may be too long and detailed and, as a result, will produce an unnecessary monetary burden to financial institutions and potentially discourage consumers from reading the notice.

In the proposed notice, the Board lists seven sections for the consumer to consider: (1) Substitute Check and Your Rights; (2) What is a Substitute Check?; (3) Your Right to File a Claim for an Expedited Refund; (4) Expedited Refunds; (5) How to Make and Expedited Refund; (6) Our Responsibilities for Handling Your Claim; and (7) Reversal of Refund. NAFCU believes that many of the sections may be shortened or combined, such as shortening the “What is a Substitute Check” and “Our Responsibilities for Handling Your Claim” sections and combining the “Substitute Check and Your Rights” section with the “What is a Substitute Check” section and the “Your Right to File a Claim for an Expedited Refund” section with the “Expedited Refund” section. NAFCU suggests the Board revise the proposed C-5 model notice and publish in the final rule a shorter model form for financial institutions to employ.

Delivery of Notice

Under Check 21, when a financial institution provides a substitute check in response to a consumer’s request, the financial institution must provide the disclosure “at the time of the request.” The Board feels that this requirement may be impracticable because, at the time of the request, the financial institution may not know whether it will be providing the consumer with an original check, substitute check, or some other copy of the check. Therefore, in its proposed rule, the Board offered two alternative rule provisions for delivery of the notice: (1) at the time of the request, or (2) at the time the financial institution provides a substitute check.

NAFCU commends the Board’s forethought in offering the two alternatives and appreciates the board’s recognition that providing a notice at the time of the request may be problematic. NAFCU offers a slight modification to the second alternative and suggests that the final rule permit the financial institution to provide the notice to the consumer *at any time from when the request is made, up to and including the time the substitute check is delivered*. NAFCU believes this will provide financial institutions with flexibility without affecting consumer awareness.

Additional Amendments to Regulation CC

Indorsement Standards

The proposed rule and commentary make several changes and clarifications to §§ 229.35(a), 229.38(d), and Appendix D with regard to indorsement standards. The proposed

changes reflect the Board's desire to create a uniform standard for both original checks and substitute checks, while taking into consideration technical constraints of existing check sorting and indorsing equipment. NAFCU generally agrees with and supports the Board's proposed changes and clarifications to indorsement standards.

The Board specifically requests comment on what benefits, if any, there would be in providing reconverting banks with the flexibility to indorse on the front of checks and to include additional information on their indorsements. Some NAFCU member credit unions felt that the additional indorsement flexibility could be beneficial but raised concerns that the checks have the potential to become too "marked up" with indorsements and, in turn, become illegible. Because of these concerns, NAFCU is not convinced that this type of flexibility would be beneficial at this time.

Regulation CC Updates & Technical Revisions

The Board proposes several amendments to existing Regulation CC and its commentary that are unrelated to Check 21. NAFCU supports these amendments, which clarify existing rules and make needed technical revisions and NAFCU does not foresee any conflict with any of the proposed changes.

Additional Requests for Comment

Treatment of Generally Applicable Industry Standards

In the proposed subpart D, the Board recommends including only a general reference to generally applicable industry standards in the rule text and, if only one industry standard applied, the proposed commentary would identify that standard. This approach would not identify the applicable standards to the exclusion of other standards that may develop over time and would account for major changes in industry standards by simply amending the commentary, rather than changing the rule itself. The Board requests comments on the desirability of this approach.

NAFCU is concerned that, because of the lack of operating experience with substitute checks, this approach may not give the financial industry enough certainty as other generally applicable standards develop. NAFCU is concerned that, because there is no formal process for what constitutes a generally applicable standard, as technology and practices develop, there is the potential for many "standards" causing confusion throughout the financial industry. NAFCU recommends the Board include in the commentary an exclusive list of generally applicable standards and amend that list as new standards emerge.

Relation of Check 21 to Other Law

Throughout the proposed commentary, the Board attempts to clarify the interaction between the rights and remedies conferred by Check 21 and those conferred by other law, particularly the U.C.C. The Board requests comment on whether the proposed commentary adequately clarifies the interaction between Check 21 and existing law, or whether additional

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discussions and examples are needed. While additional explanation may ultimately be needed or justified, NAFCU believes that it would be best to let Check 21 experience a "seasoning period" before the Board provides additional examples or clarification to the interaction of Check 21 with other check laws.

Remotely-Created Demand Drafts

Recent revisions to UCC Articles 3 and 4 have defined a remotely-created consumer item to mean "an item drawn on a consumer account, which is not created by the payor bank and does not bear a hand-written signature purporting to be the signature of the drawer." The revisions require a person who transfers or presents a remotely-created consumer item to warrant that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn. The change would allow a paying bank to use a warranty claim to absolve itself of responsibility for honoring an unauthorized item. The revisions were specifically designed to address check fraud circumstances involving remotely-created consumer checks and rest on the premise that monitoring by depository banks can control this type of fraud more effectively than any practice readily available to paying banks. The Board requests comment on whether it would be appropriate to incorporate the U.C.C. revisions into Regulation CC.

NAFCU supports amending Regulation CC to address remotely-created demand drafts and agrees that depository banks should warrant all remotely-created items. Implementing a uniform set of rules to govern these items would add consistency to the regulations and ease compliance burdens for financial institutions. NAFCU requests that the Board issue a separate proposed regulation to the financial services industry for review and comment on this important issue.

NAFCU would like to thank you for this opportunity to share its views on the proposed rules regarding the proposed changes to Regulation CC and its commentary. Should you have any questions or require additional information please contact me or Kimberly Dewey, NAFCU's Associate Director of Regulatory Affairs, at (800) 336-4644 ext. 268 or kdewey@nafcuh.org.

Sincerely,



Fred R. Becker, Jr.
President/CEO

FRB/ksd